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Dissolution of Partnership and Firm: Table of Contents 1. Meaning of Dissolution of Partnership and Partnership Firm 2. Difference between Dissolution of Partnership and Dissolution of Partnership Firm 3. Various modes of dissolution of firm 4. Realisation Account – Meaning, Preparation and Objectives 5. Difference between Revaluation Account and Realisation Account 6. Settlement of accounts in case of dissolution of firms 7. Insolvency of a partner – Rules of Garner vs Murray 8. Piecemeal Distribution – Meaning and methods of Piecemeal distribution 9. Conversion of Partnership into company or acquisition of firm by a company 10. Journal Entries in case of dissolution of Partnership Firms Dissolution of a partnership means the termination of connections with the firm by some of the partners of the firm, and remaining partners of the firm continuing the business of the firm under the same firm's name under an agreement. Hence, admission, retirement and a death of a partner are considered dissolution of partnership. The dissolution of partnership may take place in any of the following ways: a) Change in existing profit sharing ratio among partners; b) Admission of a new partner; c) Retirement of a partner; d) Death of a partner; e) Expiry of the period of partnership, if partnership is for a specific period of time; Dissolution of a firm means discontinuation of the firm's business and termination of relationship between the partners. When all the partners stop carrying on the partnership business, it is dissolution of the firm. According to Sec. 39 of Indian Partnership Act 1932, "Dissolution of firm means dissolution of partnership between all the partners in the firm." In other words, if some partners dissociate from the firm and remaining partners continue the business of the firm, it is dissolution of partnership not the dissolution of the firm. Therefore when a firm is dissolved, assets of the firm are disposed off, liabilities are paid off and the accounts of all the partners are also settled. Difference between dissolution of partnership and dissolution of firm Basis of distinction Dissolution of partnership Dissolution of firm Relationship Relationship amongst all the partners does not come to an end. Relationship amongst all the partners comes to an end. Continuation of business Business of the firm may continue. Business of the firm does not continue. Inter relationship Dissolution of partnership may or may not result in dissolution of the firm. Dissolution of the firm necessarily results in dissolution of partnership. Books of accounts Books of accounts are not closed. Books of accounts are closed. Nature Dissolution of partnership is voluntary. Dissolution of partnership may sometimes compulsory or sometimes voluntary. Account Revaluation account is prepared. Realisation account is prepared. Various modes of Dissolution of Firm The dissolution of partnership between all the partners of a firm is called the "dissolution of the firm". A firm may be dissolved with the consent of all the partners or in accordance with a contract between the partners. The Indian Partnership Act, 1932 provides that a partnership firm may be dissolved in any of the following modes: 1. Dissolution without Court's order: (i) Dissolution by agreement (Sec. 40) (ii) Compulsory dissolution (Sec. 41) (iii) Dissolution on the happening of certain contingencies (Sec. 42) (iv) Dissolution by notice of partnership at will (Sec. 43) 2. Dissolution by the court's order (i) Dissolution by agreement (Sec. 40): A firm may be dissolved with the consent of all the partners. A partnership is set up by an agreement; similarly, it can be dissolved by an agreement. If there is any contract between the partners about the mode of dissolution of the firm, it may be dissolved accordingly. (ii) Compulsory Dissolution (Sec.41): A firm is dissolved compulsorily: (a) If all the partners or a partner has been adjudicated as insolvent, then the firm is dissolved as on the date of his insolvency. (b) If any event of the business of the firm becomes unlawful, then the firm is dissolved. (iii) Dissolution on the Happening of Certain Contingencies (Sec. 42): Subject to contract between the partners, a firm is dissolved on the happening of certain contingencies: a) On expiry of the term for which the firm was constituted. b) If firm is constituted for a particular venture and that venture is completed. c) On the death of a partner; and d) By the adjudication of a partner as an insolvent. (iv) Dissolution by Notice of Partnership at Will (Sec. 43): Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm. The firm is dissolved as from the date mentioned in the notice as the date of dissolution or, if no date is so mentioned, as from the date of the communication of the notice. (v) Dissolution by Court (Sec. 44): A court may order a partnership firm to be dissolved in the following cases: a) When a partner becomes of unsound mind. b) When a partner becomes permanently incapable of performing his/her duties as a partner. c) When partner deliberately and consistently commits breach of partnership agreement. d) When a partner's conduct is likely to adversely affect the business of the firm. e) When a partner transfers his/her interest in the firm to a third party; f) When the business of the firm cannot be carried on except at a loss in future also. g) When the court considers it just and equitable to dissolve the firm. The following are the cases for the just and equitable grounds: 1. Deadlock in the management. 2. Where the partners are in talking terms between them. 3. Loss of substratum. 4. Gambling by a partner on a stock exchange. Realisation Account Realisation account is prepared at the time of dissolution of firm. Realisation Account is a nominal account. It is prepared to find out profit or loss on realisation of assets and payment of liabilities when a firm is dissolved. Any profit or loss on realisation is transferred to the capital accounts of all the partners in their profit sharing ratio. Realisation Accounts is prepared in the following manner: a) All the realisable assets given in the books of the firm are entered at their book values on the debit side of the Realisation Account b) All the external liabilities are entered at their book values on the credit side of the Realisation Account c) On the realisation of assets, the actual amount of cash received is entered on the credit side of the account. - Cash/bank account is debited d) On the payment of liabilities, the actual amount of cash paid is entered on the debit side of the account. Cash/bank account is credited e) Realisation expense if any, is also debited to the Realisation Account and bank account is credited f) After making the above entries in the Realisation Account, the account is balanced. The profit or loss on realisation is transferred to the capital accounts of all the partners in their profit sharing ratio. The main objectives of preparing realisation account are: 1) To close all the books of account at the times of dissolution of the firm. 2) To record all the transactions relating to the sale of assets and payment of liabilities. 3) To determine profit or loss due to the realisation of assets and liabilities. Difference between Revaluation Account and Realisation Account: Basis Revaluation Account Realisation Account Meaning Revaluation account is prepared in order to work out the profit or loss on revaluation of assets and liabilities. Realisation account is prepared to work out the profit or loss on realisation of assets and payment to liabilities. Preparation Revaluation account is prepared at the time of admission, retirement or death of a partner. Realisation account is prepared at the time of dissolution of a partnership firm. Closing of accounts After preparing the revaluation account the firm's business gets going with the same set of books. After preparation of Realisation account, all the accounts of the firm are closed. Remaining balance Balance of this account is transferred to the capital account of old partners. Balance of this account is transferred to the capital account of all partners. Accounting entries Entries are based on the difference between the book value and the revalued amount of assets and liabilities. Entries are based on the book value of assets and liabilities. Settlement of Accounts As soon as a firm is dissolved, the normal business of the firm is discontinued and accounts of all the partners are settled. Usually the partnership deed contains the clause for settlement of partners account. But in the absence of any agreement between the partners, the provisions of Sec. 48 of the Indian Partnership Act are followed. The accounts of the partners are settled as follow: 1) When the firm has suffered huge losses, the undistributed profits, if any, are first of all to be applied to the payment of such losses. If the profits are insufficient, the capital must be applied for payment of the losses and lastly, if necessary, contributed by the partners individually in the proportion in which they share profits. 2) When a partnership firm is dissolved, its assets are disposed of and the proceeds there from including contribution by the partners are utilised in the following manner: (a) First, in paying off the debts of the firm due to third parties; (b) Then in paying to each partner ratably any advances or loans given by him in addition to or apart from his capital contribution; (c) If any surplus is available after discharging the above liabilities, the capital contributed by the partners may be returned, if possible, in full or otherwise ratably; (d) The surplus, if any, shall be divided among the partners in their profit-sharing ratios. 3) If the amount realised by sale of assets is not sufficient to discharge the claims of the creditors in full, the deficiency can be recovered proportionately from the personal properties of the partners. If any partner becomes insolvent, the remaining solvent partners will bear the loss in their capital ratio. Insolvency of a Partner – (Rules of Garner vs. Murray) If a partner's capital account shows a debit balance on the dissolution of the firm, he is required to bring cash in the firm to settle his account. But if such partner is unable to satisfy his debt to the firm due to his insolvency, then his deficiency is to be borne by the solvent partners in accordance with the decision in Garner vs. Murray. According to the rules of Garner vs. Murray, in the absence of any agreement to the contrary, the deficiency of the insolvent partner's capital account must be borne by other solvent partners in proportion to their capital which stood before the dissolution of the firm. The effect of this ruling is to make a distinction between an ordinary loss caused due to business operation and loss on account of insolvency of a partner. Some important judgments in Garner vs. Murray case by Lord Justice Joyce was stated below: a) Loss on realisation considered being ordinary loss and therefore to be shared by all the partners according to their profit sharing ratio. b) Solvent partners to bring cash equal to their share of loss on realisation c) Loss on account of deficiency of insolvent partner considered being capital loss; therefore to be shared by solvent partners according to their last agreed capital. Accounting treatment when the firm is dissolved due to insolvency of partners: 1) When there are more than two partners and one becomes insolvent, the solvent partners are liable to bear the loss of insolvent partner. The loss is borne by the solvent partners in the following partners: a) When Garner Versus Murray rule is not applicable, the solvent partners are supposed to bear the loss according to the profit sharing ratio. b) When the Garner versus Murray rule is applicable, the solvent partners are liable to bear the loss of insolvent partners according to the ratio of last agreed capital. Last Agreed Capital means 1. In case of Fixed Capitals: Fixed Capital (as given in the Balance Sheet) without any adjustment 2. In case of Fluctuating Capitals: Capital after making adjustments for past accumulated reserves, profits or losses, drawings, Interest on capital, Interest on Drawing, remuneration to a partner etc. to the date of dissolution but before making adjustment for profit or loss on realisation. 2) In the case of dissolution of a firm where all the partners are insolvent, the following procedure should be followed: a) The Realisation Account is prepared without transferring external liabilities to it. b) Cash Account should be prepared after the Realisation Account. c) Cash in hand together with the amount realized on sale of asset and the amount received from the estate of insolvent partners shall be applied in the following order: i) For meeting the realization expenses ii) For meeting the external liabilities like bank loan, creditors, outstanding expenses, etc. iii) For meeting partners loan account. iv) For paying partners' capital account balances. Note: In case of deficiency of cash, balances of above accounts shall be transferred to the Deficiency Account. (Deficiency Account: When all the partners become insolvent, external liabilities will not be met in full and balance due from partners also cannot be recovered from partners in full. Hence, the balance due to external creditors and balance due from partners are transferred to a separate account called Deficiency Account.) Piecemeal Distribution In case of dissolution of firm, it is practically not possible to realise all the assets at a time. In fact, on the dissolution of a partnership, assets are sometimes realized gradually over a period of time. In such a case it may be agreed that different parties are to be paid in order of preference as and when assets are realized without unnecessarily waiting for the final realization of all the assets. The order of the payment will be as follows: a. Realisation expenses b. For provision for expenses that are to be made c. Preferential creditors (say, Income Tax or any payment made to the Government) d. Secured creditors – upto the amount realized from the disposal of assets by which they are secured and for the balance, if any, to be paid to unsecured creditors e. Unsecured creditors – in proportion to the amount of debts, if more than one creditor f. Partners' loan – if there is more than one partner – in that case, in proportion to the amount of loan g. And Finally, Partners' capital. The following two methods are followed to determine the order of repayment of capital of the partners: (a) Surplus Capital Method/ Proportionate Capital Method/ Highest Relative Capital Method: This method is applicable when all the partners are solvent. The following steps are to be followed to calculate the surplus capital: 1. Adjusted capital: the balance lying in the capital accounts of the partners are adjusted with the undistributed profit or loss, drawings and reserves. 2. Base capital: the adjusted capital is divided by the unit of profit share and the minimum amount is called the base capital. For example if profit sharing ratio is 5:3:2 the respective capitals will be divided by 5, 3 and 2 respectively. 3. Proportionate capital: the amount is ascertained by multiplying the base capital with unit of profit share. For example if base capital is 20,000 it is multiplied by 5,3 and 2 respectively. 4. Surplus capital: it is ascertained by the difference of adjusted capital and the proportionate capital. The process continues until we get an absolute surplus. (b) Maximum Possible Loss Method: An alternative method of piecemeal distribution amongst partner is to calculate the maximum possible loss on every realisation after the outside liabilities and the partner's loan has been paid. The amount available for distribution amongst partners is compared with the total amount of capital payable to the partners and the maximum loss is ascertained on the assumption that in future assets will not realize any amount. The maximum possible loss so ascertained is deducted from the capital balances of the partners in their profit and loss sharing ratio and the balance left in the capital account after deducting the maximum possible loss will be the amount payable to the partner. If a partner's share of maximum possible loss is more than the amount standing to the credit of his capital account, he should be treated as insolvent and his deficiency should be debited to the capital accounts of the solvent partners in the proportion of their capitals which stood on the dissolution date as stated under the Garner V/s. Murray Rule. The amount standing to the credit of the partners after debiting their share of maximum loss and their share of insolvent partners deficiency will be equal to the cash available for the distribution amongst the partners. This process of maximum possible loss is repeated on each realisation till all the assets are disposed. Conversion of Partnership into company or acquisition of firm by a company For various reasons, an existing partnership may sell its entire business to an existing Joint Stock Company which is called absorption of a partnership firm by a company or for the purpose of expansion; it can also convert itself into a Joint Stock Company which results into floatation of a new company to take over the business of the partnership. In either of the above cases, the existing partnership firm is dissolved and all the books of account are closed. The procedure of liquidation of the partnership business is same as in case of dissolution of firms but the assets of the firm are not disposed off and liabilities are not repaid instead they are transferred to the new company for a lump sum amount which is called purchase consideration. Purchase Consideration refers to the consideration payable by the purchasing company to the vendor company for taking over the assets and liabilities of Vendor Company. Accounting Standard – 14 defines the term purchase consideration as the "aggregate of the shares and other securities issued and the payment made in the form of ach or other assets by the transferee company to the shareholders of the transferor company". Although, purchase consideration refers to total payment made by purchasing company to the shareholders of Vendor Company, its calculation could be in different methods, as explained below: a. Lump sum method b. Net Assets method c. Net Payment Method a. Lump sum Method: Under this method purchase consideration will be paid in lump sum as per the valuation of purchasing companies valuation. E.g., if it is stated that A Ltd. takes over the business of B Ltd. for Rs.15, 00,000 here the sum of the Rs.15, 00,000 is the Purchase Consideration. b. Net Assets Method: Under this method P.C. shall be computed as follows: Particulars Rs. Agreed value of assets taken over Less: Agreed value of Liabilities taken over XXX XXX Purchase Consideration XXX Note: i. The term "agreed value" means the amount at which the transferor company has agreed to sell and the transferee company has agreed to take over a particular assets or a liability Otherwise book value will be the agreed value. ii. Fictitious assets (i.e., preliminary expenses, underwriting commission, discount on issue of shares, discount on issue of debentures and debit balance in P & L A/c) are not taken over. c. Net Payment Method: Under this method P.C. should be calculated by aggregating total payments made by the purchasing company. E.g.: A Ltd. had taken over B Ltd. and for that it agreed to pay Rs.5, 00,000 in cash 4, 00,000 Equity Shares of Rs.10 each fully paid at an agreed value of Rs.15 per share then the P.C. will be ascertained as follows: Particulars Rs. Cash 4,00,000 E. Shares of Rs.10 each fully paid, at Rs.15 per share 5,00,000 60,00,000 Purchase Consideration 65,00,000 Journal Entries in case of Dissolution of Partnership Firms Accounting for dissolution begins with the closing of assets and liabilities accounts by transferring them to Realisation Account. i) For transfer of assets Realisation Account Dr. To Asset Account ii) For Transfer of liabilities Liability Account Dr. To Realisation Account (Accumulated profits such as General Reserves, Profit and Loss Account Credit Balance etc. are transferred to capital Accounts in the profit sharing ratio.) iii) For transfer of accumulated profits Accumulated Profit Account (General Reserve; P&L etc.) Dr. To Partner's Capital Account Note: Provision for doubtful debts; Investment fluctuation fund, Joint life Policy Fund etc. are credited to realization account and ignored thereafter. These are internal provisions having no claim against the firm and therefore these amounts will merge into realization profit or loss and finally get transferred to Capital Accounts of partners. iv) For transfer of accumulated losses in partner's capital account Partner's capital account Dr. To Accumulated losses/Suspense Account v) For assets including unrecorded assets realized Cash/Bank account Dr To Realisation Account Note: We do not have separate asset account anymore. Realisation account is the common account representing all assets and liabilities transferred into it. Please check the next entry also. vi) For Liabilities including unrecorded liabilities are paid off Realisation Account Dr. To Cash/Bank Account vii) For assets including unrecorded assets taken over by a partner Partner's Capital Account Dr. To Realisation Account viii) For Liability taken up by the partner Realisation Account Dr. To Partner's Capital Account ix) For payment of realisation expenses Realisation Account Dr. To Cash/Bank Account x) Asset taken over by creditors: No entry; only settlement of balance amount is shown in the books. xi) For repayment of partner's loan: Partner's loan Account Dr To Cash/Bank Account xii) For distribution of Profit or Loss on Realisation If Profit Realisation Account Dr. To Partner's Capital Account If loss Partner's Capital Account Dr To Realisation Account xiii) For final payment to partners: Partner's Capital Account Dr. To Cash/Bank Account xiv) For realisation of cash from partner's in case of dissolution Cash/Bank Account Dr. To Partner's Capital Account

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